Opinion No. 88-11

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OPINION OF: HAL STRATTON, Attorney General

BY: Michael J. Vargon, Assistant Attorney General,

TO: Honorable Harroll A. Adams, State Auditor, PERA Building, Room 302, Santa Fe, New Mexico 87503

QUESTIONS

1. May a county legally invest in proprietary zero coupon securities such as CATS's (Certificate of Accrual on Treasury Securities), TIGR's (Treasury Interest Growth Receipts), and ETR's (Easy Growth Treasury Receipts)?

2. May a county participate in "overtrades" or "adjusted trades"?

3. What are the requirements concerning collateral and safekeeping of these securities, assuming they are permissible investments?

CONCLUSIONS

1. No.

2. See analysis.

3. Because the securities are not legal investments for counties, the laws about collateral and safekeeping are inapplicable.

ANALYSIS

Sections 6-10-44 and 6-10-10 NMSA 1978 set forth the permissible investments for New Mexico counties. Section 6-10-44 provides in pertinent part:

If at any time ... the treasurer of any county... has on hand more money than can be divided equitably and ratably among qualified depositories, such treasurer may, with the approval of the proper board of finance, temporarily invest such excess funds in United States bonds or treasury certificates under such rules and regulations as may be prescribed by the state board of finance.

The relevant portions of Section 6-10-10(F) state:

County ... treasurers, by and with the advice and consent of their ... boards of finance ... have the power to invest all sinking funds or money remaining unexpended from the

proceeds of any issue of bonds or other negotiable securities of any county ... which are now or may hereafter by law be entrusted to their care and custody and all money not immediately necessary for the public uses of the counties ... not invested or deposited in banks, savings and loan associations or credit unions in bonds or negotiable securities of the United States....

This section also permits investments in various state and local bonds that are not relevant to the present issue.

CATS's, and TIGR's and ETR's are zero coupon securities. Zero coupon securities are debt instruments, e.g. bonds or notes, that do not provide for periodic payments of interest or principal. Some zero coupon securities are issued in this form. In other cases, they are created by stripping the interest coupons from debt securities that periodically pay interest. In either case, the zero coupon security is deeply discounted when it is sold to the investor. For example, a bond that matures in twenty years with a face value at maturity of $1,000 might be discounted to $100. It thus would pay approximately the same return as an investment of $100 at twelve percent, compounded semi-annually over a period of twenty years. The rate of return, when held to maturity, is locked in at the time of investment.

CATS's, TIGR's and ETR's are created by stripping the interest coupons from United States Treasury bills and notes. The stripped securities then are deposited with a bank that holds them pursuant to a custody agreement. The bank then issues certificates that represent a right to payment in an amount equal to the face value of the underlying security at maturity and sells these certificates to investors at a discount. The custody agreements provide that, in the event of default by the United States, the certificate holder shall have the right to proceed directly against the United States. These agreements also provide that the custodian has no fiduciary obligation to the certificate holders and shall not be required to make any payments, except that the custodian must apply all payments received for the deposited securities to the certificate holders. The United States government is not a party to the custody agreement.

The first question is whether these certificates are bonds, treasury certificates, or negotiable securities of the United States. It is our opinion that CATS's, TIGR's and ETR's are not securities of the United States. Although the custody agreements purport to create a right in the certificate holder to proceed directly against the United States, the United States is not a party to the agreement and is not bound by it. These certificates have been described aptly as privately issued Treasury receipts collateralized by government securities. See Letter from Donald Van Weezel, Regulatory Affairs Managing Director, New York Stock Exchange, to Brandon Becker, Assistant Director of Market Regulation Division, Securities and Exchange Commission, at 3 (Oct. 31, 1986), printed in 52 Fed. Reg. 7248 n.31 (1987). The New York Stock Exchange does not classify these securities as government securities for purposes of maintenance margin rates, but, rather, as non-convertible corporate debt securities. Id.

The United States Securities and Exchange Commission has not ruled whether these particular securities are government securities. In considering a similar security, they have taken the position that "the offer and sale to the public of certificates representing undivided participations in municipal securities involved the offer and sale of a security separate from the underlying securities...." Buffalo Savings Bank, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) /P77,320 (Sept. 24, 1982). Such certificates may be considered government securities when the government issuer specifically recognizes the certificate holder as the holder of its securities. See Central Utah Rural Impact Capital Corp. Municipal Bond Pool, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) /P76,456 (July 29, 1980). The United States has not specifically recognized the holders of CATS's, TIGR's and ETR's as the holders of its securities. If the United States paid the trustee but the trustee did not pay the certificate holder, the United States would have a complete defense to any action that the certificate holder might bring. The United States would have discharged its obligation under the bond or note. We thus conclude that CATS's, TIGR's and ETR's are not bonds, treasury certificates, or negotiable instruments of the United States government. They therefore are not permissible investments for counties.

Your second question concerns the practice known as "overtrading" or "adjusted trading." It is used to cover up, or delay, realization of a loss. For example, a county might decide to sell some of its long term investments when the market price for the securities had declined. To avoid showing a loss, the county could sell the securities to a dealer who pays the county a premium, i.e., a price above the market price. The county simultaneously would purchase other securities from the same dealer and pay a premium of approximately the same amount. As a result, the transaction shows a profit on the sale of the securities and delays realization of the loss.

The law does not proscribe specifically the practice of adjusted trading. We note, however, that a county treasurer must execute a surety bond upon entering office. Section 6-10-39 NMSA 1978. The form of this bond requires the county treasurer to "render true accounts of his office and his doings therein." Engaging in adjusted trades for the purpose of hiding a loss is inconsistent with rendering a true account of the county's investments. A county treasurer thus may be liable on his bond.

Because we have concluded that the proprietary zero coupon securities in question are not permissible investments for counties, it is unnecessary to address your third question about requirements for collateral and safekeeping of such securities.

ATTORNEY GENERAL

HAL STRATTON Attorney General